SYKT. PERUMAHAN PEGAWAI KERAJAAN SDN. BHD.

v.

BANK BUMIPUTRA (M) BHD.

HIGH COURT MALAYA, KUALA LUMPUR
LIM BENG CHOON J
[SUIT NO. S7-23-436-1988]
23 MARCH 1990

CONTRACT: *Bank guarantee - Compliance with terms - Absolute or conditional - Common law principles - Section 81 Contracts Act - Indemnification - Duties of surety - Efficacy of bank guarantees.*

Under a bank guarantee dated 20 August 1986, the defendant BB agreed to guarantee in the sum of RM179,384.58 the due performance of a building contract entered into between S and the plaintiff P by which the contractor undertook to complete certain construction works for approximately RM3 million S abandoned the work and P sued for breach of the guarantee and obtained default judgment (which was later set aside). P then applied by way of summons-in-chambers for leave to enter final judgment pursuant to O. 14 of the Rules of the High Court 1980 (RHC). This was granted by the Senior Assistant Registrar. BB now appeals.

The issue for determination was whether, in view of the fact that S had alleged that P had wrongly terminated the contract and a claim for damages had been conveyed to P, could P call upon BB to honour the bank guarantee?

Held:

[1] A review of the English case law seems to suggest that a performance guarantee like an irrevocable or confirmed letter of credit is a guarantee by the bank to a seller for payment of price; the bank is not concerned with the contract entered into by its customer with the third party or any dispute between the buyer and the seller - the terms of the guarantee and the bank's obligation to pay are contained in the guarantee itself.

[2] Under s. 81 of the Contracts Act, the common law rule of disregarding whether the surety's obligation is absolute or conditional cannot apply. Since our contract statute is a replica of the Indian Contract Act 1872, the Indian authorities prove a useful guide on this area of the law.

[3] (a) S had unilaterally terminated their contract to carry out the works; this is clearly in violation of their contract with BB.

(b) Under para. 1 of the guarantee BB is bound to indemnify the plaintiff should S fail to execute the contract or commit any breach of his obligations thereunder unless relieved by the performance of any clause of the contract or by statute or by decision of a tribunal of competent jurisdiction.

(c) Any arrangement between S and BB with or without consent of BB or any alteration in the obligations of S or forbearance on the part of P is of no concern to BB.

[4] On the facts of the case and applying the legal principles of the relevant authorities, BB is bound to pay P once a demand has been made pursuant to the bank guarantee; to hold otherwise would reduce the efficacy of the bank guarantee and the trust in banks in international commerce would be irreparably damaged.

[Appeal dismissed.]

Cases referred to:
General Surety & Guarantee Co. Ltd. v. Francis Parker [1977] 6 BLR 17
Howe Richardson Scale Co. Ltd. v. Polimex-Cekop and National Westminister Bank Ltd. [1978] 1 Lloyd's Rep 161
Males (trading as Hamzah Malas & Sons) v. British Imex Industries Ltd. [1958] 1 All ER 262
Discounts Record Ltd v. Barclays Bank Ltd. [1975] 1 All ER 1071
R.D. Hardbottle (Mercantile) Ltd. v. National Westminister Bank [1977] 2 All ER 862
Edward Owen Ltd. v. Barclays Bank [1978] 1 QB 159
United Commercial Bank v. Bank of India [1981] AIR SC 1426
Damodar Paints (P) Ltd. v. Indian Oil Corporation [1982] AIR Delhi 57
Pesticides India v. State Chemicals & Pharmaceuticals Corporation of India [1982] AIR Delhi 78

Legislation referred to:
Contracts Act 1950, s. 81
Rules of High Court 1980, O. 14

Other sources referred to:
Modern Contract of Guarantee by O'Donovan, [1985] Edn., p. 605
Jowitts Dictionary of English Law, 2nd Edn. Vol. 1 p. 741

For the plaintiff - Zainal Abidin bin Jamal; M/s. Zainal Abidin & Co.
For the defendants - S. Suhendran; M/s. Saheran & Woon

[Editor's Note: The defendants have lodged an appeal to the Supreme Court *vide* Civil Appeal No. 03-43-90.]

JUDGMENT

Lim Beng Choon J:

This is an appeal by the defendant against the decision of the Senior Assistant Registrar given on 30 January 1989 granting the plaintiff leave to enter final judgment of the sum of RM179,384.58 together with interest and costs pursuant to O. 14 of the Rules of High Court 1980 ("the RHC").

The cause of action of the plaintiff was grounded on the alleged breach of a bank guarantee dated 20 August 1986 ('the bank guarantee') whereby the defendant agreed to guarantee, in the sum of RM179,384.58, the due performance of the contract dated 24 November 1986 ('the building contract') entered into between Sarikon Sdn. Bhd. ('Sarikon') and the plaintiff by which the Contractor undertook to complete certain construction works for the sum of RM3,587,691.62. The action of the plaintiff was instituted on 16 August 1988 by a writ endorsed with a statement of claim. The plaintiff obtained judgment in default of appearance. However the default judgment was later set aside on ground which is not relevant to the matter which I have been asked to decide. On 23 November 1988 the plaintiff applied by way of summons-in-chambers for leave to enter final judgment pursuant to O. 14 of the RHC (see encl. 14). In support of the application the plaintiff's deputy managing director affirmed an affidavit (encl. 13) in which it was

alleged *inter alia* that on 15 December 1987 the receivers and managers of the Sarikon informed the plaintiff by telex of their intention to terminate all works under the building contract with effect from 18 December 1987 and Sarikon did on that date abandon the works on site. It was therefore asserted that by reason of the abandonment of works the plaintiff properly terminated the Contract and called upon the defendant to honour the bank guarantee which the plaintiff did by their letter of 22 December 1987. The defendant, however, refused to honour the bank guarantee notwithstanding that the bank guarantee, according to the plaintiff, stood on the same footing as a letter of credit and defendant as a bank was bound to honour the same upon its terms. The plaintiffs therefore claimed that the defendants could not have any defence to their action and that the defendant was truly indebted to them for the sum stated in their statement of claim.

The defendants had through their manager of the credit recovery department filed in three affidavits in which a number of allegations were made. However at the hearing of the defendant's appeal against the SAR's decision, Counsel for the defendants submitted that there was only one issue before this Court namely that in view of the fact that Sarikon had alleged that the plaintiff had wrongly terminated the Contract and a claim for damages had been conveyed to the plaintiffs could the plaintiffs call upon the defendants to honour the bank guarantee? In support of his contention Counsel drew my attention to the following passage from the text book on *Modern Contract of Guarantee* by O'Donovan (1985 Edn.) where the author said at p. 605:

> Performance bonds are of two types. The first type is a conditional performance bond, whereby the guarantor only becomes liable upon proof of a breach of the terms of the principal contract by the builder, and the owner sustaining loss as a result of such breach. The guarantor's liability, therefore, will only arise in the usual way as a result of the principal's default. The second type of performance bond is an unconditional or "on-demand" performance bond which is so drafted that the guarantor will become liable merely when demand is made upon him by the owner.

In referring to the bank guarantee in the present case Counsel suggested that it came under the former class of performance bonds as stated in the aforesaid passage. Counsel also drew my attention to the case of *General Surety & Guarantee Co. Ltd. v. Francis Parker* [1977] 6 BLR 17 where it was held that the plaintiffs were only liable to the employer to the extent that it could prove that the contractor had made default and that sums of money, damages, costs, charges and for expenses had become due and payable by the contractor to the employer by reason or in consequence of that default.

Counsel for the plaintiff, on the other hand, submitted that it was not 'the duty' of the defendant bank to enquire whether there was a dispute between Sarikon and the plaintiff and he drew my attention to the case of *Howe Richardson Scale Co. Ltd. v. Polimex-Cekop and National Westminister Bank Ltd.* [1978] 1 Llyd's Law Report 161 where it has been held that the position of the bank which gave the guarantee is not identical with but very similar to the position of a bank which has opened a confirmed irrevocable letter of credit and that whether the obligation arises under a letter of credit or under a guarantee, the obligation is the same namely the said bank is bound to pay regardless of any dispute as to the sufficiency of performance between the indemnified and third party. It has also been suggested in that case that the Court is not concerned whether the bank's obligation is absolute or not.

A review of the English case law seems to suggest that a performance guarantee like an irrevocable or confirmed letter of credit is a guarantee by the bank to a seller for payment of price. The bank is not concerned with the contract entered into by its customer with the third party or any dispute between the buyer and the seller. The terms of the guarantee and the bank's obligation to pay are contained in the guarantee itself. There is a line of English authorities acknowledging this proposition - see for example *Malas (trading as Hamzah Malas & Sons) v. British Imex Industries Ltd.* [1958] 1 All ER 262, *Discounts Record Ltd. v. Barclays Bank Ltd.* [1975] 1 All ER 1071 and *R.D. Hardbottle (Mercantile) Ltd. v. National Westminister Bank* [1977] 2 All ER 862. The principle laid down in these authorities has been considered by the English Court of Appeal in *Edward Owen Ltd. v. Barclays Bank* [1978] 1 QB 159. Thus Lord Denning said at p. 171 of the reported case:

> All this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is a clear fraud of which the bank has notice.

However that may be the question to ask and to be answered is whether the English common law principle can apply to a performance guarantee given in our country in view of s. 81 of our Contracts Act 1950? That section says:

> 81. The liability of the surety is co-extensive with that of the principal debtor *unless it is otherwise provided by the contract.*
>
> (Emphasis is mine).

To my mind, the words underlined by me are of some significance. The said words reduce the efficacy of the provision that the liability of the surety is co-existent with that of the principal debtor in cases where a surety has executed an agreement of guarantee or indemnity with the person indemnified indicating that the surety would pay subject only to the terms of the said agreement. In this respect therefore the English common law rule of disregarding whether the surety's obligation is absolute or conditional cannot apply. Since our contract statute is a replica of the Indian Contract Act 1872, it is useful to look into the Indian authorities in order to find out how the Indian Courts deal with the issue. The answer to the issue can be found in *United Commercial Bank v. Bank of India* [1981] *AIR* SC 1426 where it is stated:

> A bank which gives a performance guarantee must honour that guarantee according to the terms. In *R.D. Harbottle (Mercantile) Ltd. v. National Westminister Bank Ltd.*, [1977] 3 WLR 752, Kerr J considered the position in principle. We would like to adopt a passage from his judgment at p. 761: It is only in exceptional cases that the Courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce. Such obligations are regarded as collateral to the underlying rights and obligations between the merchants at either end of the banking chain. Except possibly in clear cases of fraud of which the banks have notice, the Courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to them or stipulated in the contracts. The Courts are not concerned with their difficulties to enforce such claims; these are risks which the merchants take. In this case the plaintiffs

took the risk of the unconditional wording of the guarantees. The machinery and commitments of banks are on a different level. They must be allowed to be honoured, free from interference by the Courts. Otherwise trust in international commerce could be irreparably damaged.

Again it was held in *Damodar Paints (P) Ltd. v. Indian Oil Corporation* [1982] AIR Delhi 57 that an irrevocable performance bank guarantee is a distinct separate transaction. If disputes arise between the company on whose behalf the guarantee is given and a corporation in whose favour it is given and the disputes are referred to arbitration the payment of the guarantee cannot be stayed pending the arbitration. This proposition is followed in *Pesticides India v. State Chemicals & Pharmaceuticals Corporation of India* [1982] AIR Delhi 78.

The next step I need to take is whether the defendant bank in the present case is bound absolutely by the terms of the bank guarantee to pay the plaintiff on demand. The facts that are not in dispute are that the contractor Sarikon, had abandoned works on site and by reason of the abandonment of works the plaintiffs had properly terminated the contract with Sarikon - see para. 7 of the affidavit (encl. 13) in support of the plaintiff affirmed by their deputy managing director on 21 November 1988 and Exhibits "TKE2", "TKE3" and "TKE4" annexed to that affidavit. Furthermore the authorised representatives of Sarikon at the site meeting held on 12 November 1987 (see Exhibit 'TKE5' annexed to the affidavit in reply affirmed by the deputy manager of the plaintiff bank on 2 October 1988 - encl. 10) agreed that if Sarikon had to abandon the works then the defendant could call in another contractor to do the works in which case the defendant would be entitled to forfeit "the performance bond." Although I accept that the remarks of the authorised representatives of Sarikon could not bind the plaintiff nevertheless their remarks clearly showed that Sarikon had unilaterally terminated their contract to carry out the works. This is clearly in violation of their contract with the defendant annexed as Exhibit 'TKE3' in encl. 10.

Adverting to the bank guarantee, its heading states "**bank guarantee for the performance bond**" (Emphasis is mine) and in recital (2) it is stated:

The guarantor has agreed to guarantee the due performance of the contract in the manner hereinafter appearing.

The crucial condition appears in para. (1) of the said agreement which reads:

(1) If the Contractor (unless relieved from the performance by any clause of the contractor or by statute or by decision of a tribunal of competent jurisdiction) shall in any respect fail to execute the contract or commit any breach of his obligation thereunder then the guarantor will indemnify and pay the Principal the sum of Ringgit Malaysia: One Hundred Seventy Nine Thousand Three Hundred Eighty Four and Sen Fifty Eight only (RM179,384.58) provided that the Principal or his authorised representatives has made a claim against the guarantor not later than six (6) months after the expiry date of the Contract.

It can at once be noted that the defendant is bound to indemnity the plaintiff should Sarikon fail to execute the contract or commit any breach of his obligations thereunder unless relieved from the performance by any clause of the contract or by statute or by decision of a tribunal of competent jurisdiction. When Sarikon failed to execute the contract that is when they failed "to complete and carry into effect" the works (see meaning of

"execute" as defined in *Jowitts Dictionary of English Law* 2nd Edn. Vol. 1 p. 741) and not excused by any term in the contract or the decision of a tribunal made before the demand for indemnify by the plaintiff to the defendant under the terms of the bank guarantee then the defendant is bound to pay on demand. Any arrangement between Sarikon and the defendant with or without consent of the defendant or any alteration in the obligations of Sarikon or forbearance on the part of the plaintiff is of no concern of the defendant (see condition 12 of the bank guarantee). In the circumstances and applying the legal principle enunciated in the aforementioned authorities I have no hesitation in holding that the defendant is bound to pay the plaintiff once a demand has been made pursuant to the bank guarantee. To hold otherwise would reduce the efficacy of the bank guarantee and the trust in banks in international commerce would be irreparably damaged.

The appeal of the defendant against the decision of the SAR dated 30 January 1989 is therefore dismissed with costs.

Also found at [1990] 2 CLJ 1052